

North Carolina Community Development Financial Institutions (CDFIs):
Case Studies of Two Nonprofit Organizations In a Changing Industry

by

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A Masters Project submitted to the faculty
of the University of North Carolina at Chapel Hill
in partial fulfillment of the requirements
for the degree of Master of Regional Planning
in the Department of City and Regional Planning.

Chapel Hill

April, 2007

Approved by:

 ADVISOR

CHAPTER 1: THE CDFI INDUSTRY, PAST AND PRESENT

My first job after college was as an Americorps*VISTA volunteer with ACCION Texas, a nonprofit Community Development Financial Institution (CDFI) with a mission to provide small business loans to low-income entrepreneurs. As a loan officer, I worked with people like Bernard Sebastian,¹ a 27-year-old ex-convict and an airport employee. He owned a small dry cleaning business in East Austin, a part of the city where every store's windows were incased in iron bars and a "condemned" poster hung on the front door of at least one home on every block. Though his business had surprisingly strong community support – "you know we look good over here on, no wrinkled shirts," he'd tell me – his dilapidated neighborhood presented two obstacles. First, his shop had been repeatedly vandalized by rowdy kids, costing him hundreds of dollars in repairs. Additionally, he was unable to expand his client base beyond his community because his neighborhood intimidated outsiders who feared wandering into his side of town.

To address these problems, Bernard wanted a \$4,000 loan from ACCION Texas. He'd use a portion of the money to construct a fence around his shop to curb the vandalism. With the remaining funds he'd purchase a used truck large enough to carry large quantities of clothes. He planned to offer a new dry cleaning delivery service, reasoning that if Austin would not come to him he would travel to Austin. His new marketing slogan: "Let me fight traffic for you."

By all accounts Bernard was a risky loan. The three years he'd spent in prison had left him with deplorable credit, and his income was already stretched thin due to prior financial obligations. His collateral was weak – paperclips, jewelry he had given his

¹ Name changed to protect individual's privacy.

girlfriend – and his business receipts were literally kept in a shoebox, pouring out in all directions and utterly unorganized. Yet, he was also one of my most committed clients. And in mission-driven lending, such as ACCION Texas’ work, personal conviction and competency are worth a lot.

Though I aggressively lobbied Bernard’s loan application, ACCION Texas refused to lend him the entire \$4,000 he’d requested. Instead, we compromised on a smaller loan amount that would allow him to purchase the used truck with the understanding that he could apply for more money the following year if he repaid this first loan on time.

Along with Bernard’s loan came technical assistance in the form of his young, eager loan officer. I taught him how to track his sales, how to create basic financial statements and how to keep a budget. He bought a used computer and automated his bookkeeping system. Business slowly improved and eighteen months later he applied for a \$20,000 loan from another nonprofit CDFI. I helped him complete the application and also served as one of his references.

My work with Bernard obviously impacted his business, but it also affected me. Bernard taught me that there are a lot of smart, motivated people whose needs go unmet, that the resources I can access any time of day are completely unavailable to certain segments of the population, and that I can play a role in making things a little better for some people somewhere.

The best way for me to do that was to work for a CDFI.

In this paper, I examine how North Carolina's nonprofit CDFIs are responding to a changing CDFI industry. Specifically, as federal funding sources shrink and competition from traditional lenders increases, nonprofit CDFIs are adopting more market-oriented strategies to remain relevant and to achieve their mission of placing affordable capital in underserved communities. While exciting innovations have been spurred by the evolving industry, the transition has not necessarily been easy for CDFIs. This paper traces the changes currently occurring in the CDFI industry, considers how two nonprofit CDFIs in North Carolina are affected by, and are addressing, those changes, and closes with policy recommendations to bolster North Carolina's CDFI community.

I elected to study the nonprofit CDFI community's response to the increasingly complex world of community development finance for two reasons. First, I am curious to understand how the field has changed since its inception in the late 1960s, when racism was explicit, redlining the norm, and the civil rights movement had community activists itching for change. I wondered if the communities that CDFIs served had changed as their lending practices evolved and, if so, in what ways. Were there deals that could have been financed in the 1970s that would no longer happen because of new underwriting criteria? Was the CDFI's mission still of highest priority regardless of whatever financial pressures were placed on the organization to meet certain profitability criteria? This paper presented me the opportunity to explore those questions, at least as far they apply to two nonprofit CDFIs based in North Carolina.

A second reason I wanted to research this topic is because I believe profoundly in the importance of CDFIs and their ability to address at least a portion of the needs of

distressed communities. In North Carolina alone, there are approximately thirty CDFIs. At the end of fiscal year 2003, North Carolina CDFIs had invested more than \$1.08 billion in almost 20,000 customers. Of those 20,000 people, roughly 70% are low-income, 83% are minorities, and 52% are female.² According to the CDFI Coalition, in one year North Carolina's CDFIs achieved the following:

- Financed roughly 3,800 customers
- Provided asset-building savings and retail financial services to 43,299 people
- Financed 26 community service organizations, creating and supporting 1,051 childcare slots and 2,492 education slots
- Closed 9,146 mortgages
- Created or renovated 134 affordable housing units
- Financed 284 businesses/microenterprises, creating and supporting 1,933 jobs
- Opened 4,000 first bank accounts
- Made 550 loans to people with no credit history

North Carolina's CDFIs have clearly invested not only considerable capital but, more specifically, they have served poor communities whose financing needs have not been met by traditional lenders. Given the demonstrable impact of CDFIs, and the great need that continues to plague distressed communities, North Carolina needs strong, competent CDFIs. Thus, it is imperative that we understand the strengths, weaknesses and challenges North Carolina CDFIs are facing in this changing market in order to best support them in their quest to help our state's disenfranchised residents.

² Coalition of Community Development Financial Institutions.
<http://www.cdfi.org/states/NorthCarolina.pdf>. Consulted on April 5, 2007.

Methodology

This paper was designed to incorporate both current research in the field of community development finance as well as case studies specific to North Carolina. Thus, it draws from both primary and secondary sources. Thankfully, there already exists excellent literature on the history and current state of the national CDFIs industry, and I relied on experienced researchers and existing work to inform my understanding of the field. As for the portion of this paper that is specific to the North Carolina CDFI community, I gathered the majority of my data from qualitative interviews with community development practitioners active in the state's industry.

Specifically, I interviewed three employees at Self-Help, including the President of the Self-Help Ventures Fund, the Vice President of Commercial Lending, and the Vice President of Real Estate and Facilities Lending. I also interviewed the President of Initiative Capital and Initiative Capital's Vice President of Commercial Development. I used a semi-structured interview guide designed to cover the broad themes of how the organizations have changed their business model in light of decreased federal CDFI funding, technological and market analysis innovations within the industry, and the CDFIs ability to achieve the desired social impact in a changing financing landscape.

A key secondary source was the Capital Xchange Journal, a publication jointly produced by the Brookings Institution and the Joint Center for Housing Studies at Harvard University. As part of the Brookings Institution's Metropolitan Policy Program, the Capital Xchange Journal is "a journal about transforming markets and transforming

places.”³ Contributors include experienced community development practitioners as well as academics, and articles focus on the intersection of community economic development and finance, including housing markets, banking services and redevelopment projects, capital markets and, of course, community development financial institutions. Another important secondary source was the Coalition of Community Development Financial Institutions, an advocacy group that works to increase awareness of, and support for, its national network of CDFI member organizations.

Because the CDFI industry includes a wide variety of organizations with multiple business models and philosophies, it was necessary to narrow the focus of my research. Thus, this paper is limited to nonprofit CDFIs engaged in commercial lending activities, including both residential and commercial real estate lending as well as small business loans. The two case studies included in this paper are even more targeted, as they are restricted to nonprofit CDFIs that are not only involved in commercial lending activities but are also based in North Carolina. It is my hope that in narrowly defining the scope of this research I can better understand how one very specific segment of the CDFI market – commercial loans – is responding to the changing environment in which CDFIs now operate.

This paper consists of four sections. The first chapter opens with a definition of CDFIs before reviewing the history of the industry. The chapter then discusses the state of today’s CDFIs, focusing primarily on the industry’s impressive achievements so as to demonstrate both the scope and importance of CDFI work. Next is a detailed analysis of the changes currently occurring in the CDFI industry. Specifically, the chapter explores

³ Capital Xchange Journal. <http://www.brookings.edu/es/urban/capitalxchange.htm>. Consulted on April 12, 2007.

the ways in which changing investor expectations, increased competition and evolving markets are forcing CDFIs to revisit their business models. This first chapter includes a detailed discussion of new financial products recently introduced to CDFIs, as well as a conversation around technological advances. Chapters two and three rely on case studies to outline how two North Carolina CDFIs – Initiative Capital and The Center for Community Self-Help – are responding to the changing CDFI landscape. The two case studies illustrate the ways in which CDFIs are not only augmenting the services they offer but also exploring alternative tools for financing their own work. Lastly, the paper concludes with a chapter on policy recommendations to strengthen and support North Carolina CDFIs in light of the evolving industry.

Ultimately I conclude that the changing industry landscape affects CDFIs both with regards to the way they finance their own operations and the financial products they are able to offer their borrowers. A large CDFI, like Self-Help, that is financially self-sustaining, is much better positioned to weather the current decline in federal funding for CDFIs than a small organization like Initiative Capital, who has had to turn to the traditional capital markets for more expensive funding as subsidized funding has decreased. The degree to which a CDFI does or does not rely on external funding to maintain its operations significantly impacts the services it can offer its borrowers. Initiative Capital, for example, who relies more on market-rate financing to maintain its operations, has to price its loan products such that they can repay their own loans. Conversely, Self-Help, whose funding is primarily either internally generated or pulled from the deposits it collects from its customers, can target a lower required rate of return on its products, in turn enabling them to offer more affordable services to their customers.

Introduction to CDFIs

Community Development Financial Institutions (CDFIs) are defined as “private-sector, financial intermediaries with community development as their primary definition.”⁴ This definition is the most widely used due to its broad nature – in being vague it encompasses the many and varied entities that qualify as CDFIs. Specifically, there are four types of CDFIs. There are two forms of CDFIs that act as depository institutions: community development banks (ShoreBank, for example) and community development credit unions (Self-Help, for example). Additionally, there are two types of non-depository CDFIs: community development loans funds (NC Initiative, for example) and community development venture funds (Sustainable Jobs Fund, for example).

Regardless of their structure, all CDFIs share certain characteristics, including:

- Mission-based approach that prioritizes social and/or environmental issues
- Commitment to operating just outside of conventional financial institutions
- Targeted strategy of providing needed capital to underserved individuals, communities and businesses.

Within this framework, the approach employed by the various CDFIs varies.

Community development banks and credit unions function in many ways like more traditional depository institutions in so far as they provide both consumer and commercial financial services, including industry standards like checking accounts, saving accounts, Certificates of Deposits, personal loans, business loans, and home mortgages. Where CDFIs differ from traditional depository institutions is usually in the customers they

⁴ Coalition of Community Development Financial Institutions.
<http://www.cdfi.org/whatare.asp>. Consulted on April 5, 2007.

serve, and/or the terms offered on their loans. Due to the very fact that CDFIs target underserved and low-income communities, they typically service a clientele considered “high risk” by conventional financial indicators. As a result, CDFIs mostly serve communities that other financial services providers are unwilling to do business with. Because CDFI clients are often categorized as high-risk borrowers, CDFIs may or may not charge a higher interest rate than that of a traditional bank in order to compensate for the risky nature of the transaction.

Similarly, community development venture funds engage in much the same work as their more traditional counterparts, but approach their work from the perspective of satisfying their mission. For example, the Sustainable Jobs Fund, a community development venture fund in Durham, NC, finances businesses with an environmentally responsible business model, such as clean technologies, or a model that contributes to positive workforce development through the creation of jobs that pay livable wages and create healthy work environments.⁵ Community development loan funds also invest in businesses, but are usually more focused on financing businesses that address community needs. Thus, many community development loan funds finance high quality, locally owned day care centers, affordable housing developments, community arts facilities, and small storefront businesses.

⁵ SJF Ventures. <http://www.sjfund.com>. Consulted on February 27, 2007.

Brief History of CDFI Industry

The term “CDFI” first entered the American vocabulary in the mid-1960s amid a population tired of the banking community’s redlining practices, inspired to fight for social justice by the Civil Rights Movement, and acutely aware of the country’s racial and economic disparities. Burned by the mighty promises, but ultimately short-lived reality, of President Lyndon B. Johnson’s Great Society program, and hungry for a solution to the stories of American poverty and violence so rampant during the period, Americans decided to take matters into their own hands. Across the nation, residents in distressed communities organized themselves, arguing that there was no need to wait for outsiders to come in and fix their neighborhoods when they could do it themselves, right now. Out of this determination, and with funding from the Johnson administration’s federal Office of Opportunity “Special Impact Program,” were born the country’s first Community Development Corporations (CDCs), including the Bedford-Stuyvesant Restoration Corporation in Brooklyn New York in 1967 and the Kentucky Highlands Investment Corporation in Appalachian Kentucky in 1968. It was these first-generation CDCs that gave birth to the CDFI industry in the late 1960s and early 1970s.

Like many of their contemporaries, these earliest organizations focused on providing mortgages and business financing to low-income communities. They believed fervently that many of the problems facing distressed communities, such as lack of affordable housing, dangerous neighborhoods, and high poverty rates, were due to communities’ unmet capital needs. The earliest CDCs and CDFIs posited that in providing the needed money to satisfy these capital gaps, they would develop, both literally and figuratively, solutions to such ills. These first community development

financial institutions viewed themselves as operating on a parallel, but distinctly different, plane than that of traditional banks and financing institutions. Whereas traditional financial service providers engaged in redlining and other discriminatory practices that created and fueled the financing gaps, these CDFIs worked exclusively in those underserved markets. They were proud of this intentional “separateness,” and approached their work from a place of contentious distance from the mainstream capital markets.

In the 1970s, numerous new CDFIs were created, including the famous South Shore Bank (now ShoreBank) in Chicago in 1973 and the Neighborhood Reinvestment Corporation (now Neighborworks America), also in 1973. During this period, CDFIs were well able to maintain their separateness from mainstream financial institutions in part because of the way the early CDFIs were funded. Unlike many of today’s CDFIs, who routinely accept money from commercial banks, first-generation community development financial institutions were financed either with public funds from HUD, the Economic Development Administration, the Department of Agriculture, or from philanthropic individuals, community groups and religious organizations. They had little, if any, interaction with commercial banks and credit unions.

In the late 1970s and 1980s, just as the CDFI industry began to crystallize into a recognizable movement, the American political landscape changed. Specifically, two changes in federal policy directly effected the development of the CDFI methodology. First, Congress introduced the Community Reinvestment Act in 1977 (CRA), permanently putting an end to the self-imposed distance CDFIs had previously maintained from commercial financial institutions. Designed to curb redlining practices

and provide all Americans equal access to financial services, the CRA required depository institutions to provide loans, investment opportunities and other financial services to communities located within three to five miles of a bank's branch, regardless of the community's racial, ethnic or demographic composition. In the case of very large institutions with branches dispersed in great numbers, the CRA required the institution to service the entire county or even the entire state. Whereas commercial lenders had previously been able to discriminate against various populations, the introduction of the CRA, and its attendant monitoring system, forced the notion of good stewardship upon the banks, requiring them to service the neighborhoods in which the bank was located. Suddenly, with the introduction of the CRA, CDFIs and commercial institutions would, at least in theory, service the same clients.

A second major policy change was the introduction of the Low-Income Housing Tax Credit (LIHTC) as part of the 1986 Tax Reform Act. Like the CRA, the LIHTC was created as a tool to integrate mainstream financial service providers into the community development field. The LIHTC offered financial incentives to corporate investors to place equity in affordable housing developments targeted at low-income renters. The LIHTC was very successful at luring private investors into the world of affordable housing developments, and as a result, for-profit developers, commercial banks, and institutional investors were quickly coming to control an industry previously left to CDFIs, non-profit developers and HUD's Section 8 voucher program. By all accounts the LIHTCs have greatly increased the size and quality of America's affordable housing stock, and the program was introduced at the perfect moment in time given the Reagan Administration's dissemination of the Section 8 program in the mid-1980s. However, the

LIHTC also had the secondary impact of changing the dialogue of CDFI work. In the same way the CRA shrunk the distance between the work of the CDFIs and that of mainstream financial institutions, so too did the introduction of LIHTCs.

Thus, the 1980s was a simultaneously strange and exciting time for CDFIs. On the one hand, the identity of CDFIs as institutions working outside the mainstream capital markets was challenged as commercial banks and credit unions became more heavily involved in affordable housing developments. On the other hand, there was a sense, perhaps even recognition, that there was something powerful and important about providing financial services to low-income communities. The result was an evolution within the CDFI industry. Specifically, as explained by Kristin Moy and Alan Okagaki, there were four distinct changes to the CDFI strategy:

1. *Partnerships:* As CDFIs and commercial institutions began interacting more, either under the auspices of CRA or through LIHTC projects they jointly financed, the sense of CDFIs as intentionally separate from commercial banks dissipated. While CDFIs were quick to distinguish between their mission-driven principals and the profit-oriented values of traditional banks, they nonetheless began to create partnerships, further diminishing the sense of separateness once so prevalent among CDFIs.
2. *Specialization:* Prior to the CRA and LIHTC program, there was a general consensus among the CDFI community that commercial banks would simply not service low-income neighborhoods in any manner, meaning CDFIs would have to do it all themselves. The result was a hodge-podge mix of CDFIs who administered everything from small business loan funds to mortgages, anything

absent from redlined communities. Once commercial institutions entered the scene, CDFIs were able to become somewhat specialized, focusing on the niches they were best able to serve while leaving the banks to address other financing needs.

3. *Innovations:* As CDFIs became more involved in the mainstream capital markets, they facilitated knowledge and information exchanges between traditional financiers and community development practitioners. The result was innovations in the CDFI industry that enhanced performance and delivery of needed services.
4. *Competition:* As mentioned earlier, the CRA and LIHTC programs brought with them competition from commercial banks that were suddenly servicing neighborhoods previously understood to fall exclusively in the jurisdiction of CDFIs. This competition both furthered the innovations occurring within the CDFI field as the community development lenders struggled to remain competitive against the more streamlined, experienced traditional lenders and also forced some CDFIs out of certain market niches into others.⁶

CDFIs continued to evolve throughout the 1980s and into the 1990s, when the industry experienced another major policy change. In September 1994, President Bill Clinton signed into the law the CDFI Act of 1994, which created the CDFI Fund, a federal fund designed to support existing CDFIs and assist in the development of new ones. Without going into a history of the CDFI Fund, it is interesting to note that Bill

⁶ Kristen Moy and Alan Okagaki, “Changing Capital Markets and Their Implications for Community Development Finance,” *Capital Xchange Journal*, (July, 2001).

Clinton's campaign platform included the promise he made in front of South Shore Bank, in Chicago, to create exactly such a fund if elected President. Clearly, by the mid-1990s, CDFIs had gained enough credibility to not only merit a stop on a campaign tour for president of the United States, but also to be included in a presidential agenda. The CDFI industry was gaining momentum, and would explode under the creation of the CDFI Fund.

Capitalized with an initial appropriation of \$125 million for its first fiscal year and emboldened with substantial bipartisan political support from Democrats who liked its social mission and Republicans who appreciated its free market approach, the CDFI Fund was an integral part of the industry's rapid growth in the mid- and late-1990s. The Fund, which provided debt, equity, operating grants and technical assistance to certified CDFIs, made annual awards to CDFIs through a competitive process in which organizations could apply for a maximum of \$5 million. When Clinton created the CDFI Fund, there were roughly 300 CDFIs scattered across the country. Ten years later, there were almost 1,000 CDFIs, with a CDFI in every state in America.⁷⁸

State of Today's CDFI Industry

The state of today's CDFI industry is a complicated mix of exciting and distressing perspectives. On the one hand, the industry is booming. At the same time, CDFIs are operating in increasingly competitive environments while simultaneously

⁷ There is a distinction between CDFIs that are certified by the federal fund, and CDFIs that are not certified. This number of almost 1000 refers to all CDFIs, not just those that are certified. Similarly, this paper considers all CDFIs, regardless of certification status.

⁸ All data in this paragraph courtesy of the National Housing Institute.
<http://www.nhi.org/online/issues/79/coallaw.html>. Consulted on March 10, 2007.

struggling both for funding and for methodologies that enable their work to remain relevant and useful. To fully understand today's CDFI industry, it is necessary to examine not only the work of the CDFIs themselves, but also the policy climate in which they exist.

The CDFI movement has made great advances since its inception. In Fiscal Year (FY) 2004 alone, CDFIs invested an estimated \$3.5 billion in community economic development projects across the United States. Specifically, according to the 2004 CDFI Data Project, in FY 2004 CDFIs:

- Financed 6,887 businesses that created or maintained 28,330 jobs;
- Facilitated the construction or renovation of 43,160 units of affordable housing;
- Built or renovated 470 community facilities in low-income communities; and
- Assisted 122,755 economically disadvantaged individuals to open their first bank account.⁹

Clearly, today's CDFIs are achieving substantial mission impact. However, these numbers only tell half the story of the industry's good works. Research also indicates that CDFIs are serving communities still neglected, or at least underserved, by traditional lenders evidenced by the fact that in 2004, 70% of CDFI customers were low-income and 58% were minority, populations often overlooked by commercial institutions.

In addition to their strong mission impact, today's CDFIs are financially robust. In FY 2004, CDFIs managed \$18.3 billion in assets and \$17.5 billion of capital. While these are impressive figures, it is important to place them in the context of the larger capital

⁹ Coalition of Community Development Financial Institutions.
<http://www.cdfi.org/cdfiproj.asp#fy>. Consulted on March 5, 2007.

markets.¹⁰ In 2004, U.S. financial institutions controlled more than \$10 trillion in assets, dwarfing the size of the CDFI industry.¹¹ Thus, though CDFIs control significant assets, a comparison of CDFIs and mainstream financial institutions indicates that CDFIs remain very much a niche player in the capital markets, as CDFIs manage only 0.18% of the assets of the mainstream industry.

Despite their impressive track record, CDFIs continue to face major challenges. The policy environment that was once so supportive of CDFIs has been decimated by the current presidential administration of George W. Bush. In 2002, Congress cut appropriations to the CDFI Fund by 32%, from the \$118 million the Fund received in 2001 to a frustratingly low \$80 million (which was \$12 million above the \$68 million appropriations level supported by the White House). By 2006, the Fund had been further reduced to \$55 million in appropriations, representing less than half of its 2000 appropriation of \$115 million under then-president Clinton six years earlier. Sadly, this \$55 million appropriation was viewed as a victory by some in the CDFI community given that President Bush's budget recommendation for FY 2006 was \$8 million for the Fund.¹²

Like the CDFI Fund, the CRA was revised under the Bush administration to the detriment of the CDFI community. In 2005, under pressure from commercial banks – none of whom had ever supported the CRA and who correctly identified the Bush Administration as receptive to their complaints – the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Office of the Comptroller of the Currency jointly backed policies that considerably weakened enforcement of the CRA

¹⁰ Ibid.

¹¹ Data as of December 31, 2004, according to Federal Deposit Insurance Corporation.

¹² Coalition of Community Development Financial Institutions.
<http://www.cdfi.org/approp.asp>. Consulted on March 15, 2007

and decreased the obligations placed on banks to service economically distressed communities either through direct investment or through financing CDFIs.

The combined effect of the decreased funding for the CDFI Fund and the relaxed requirements of the new CRA have resulted in funding shortages for some CDFIs, many of whom have long relied on these two key federal policies to provide grants and low-cost capital.¹³ In addition to changing political environments, CDFIs are facing challenges from competing institutions. As Kristin Moy and Alan Okagaki rightly assert, “ironically, the redlining of the 1970s gave CDFIs protected market niches. Today’s CDFI industry is much less separate from mainstream capital markets, but with the exception of a relative handful of high performing institutions, it lacks the sophistication, supporting infrastructure and resources to compete with conventional institutions.”¹⁴

And yet, compete is exactly what CDFIs are forced to do in today’s capital markets. Mark Pinsky explains it well when he writes,

“In the late 1990s, banks moved downstream in the credit markets as the sustained U.S. economic boom resulted in high levels of prime credit market saturation. Eventually, the banks found themselves competing for deals with CDFIs that they had helped to finance (capitalize) or fund (provide grants to). This set off a push-and-shove match between the banks and CDFIs, with each insisting that the other get out of their respective markets.”¹⁵

Such competition has further challenged CDFIs’ traditional business model. Where first generation CDFIs could, unfortunately, identify numerous financing gaps in underserved

¹³ Of course, there are other federal funding sources that have arisen to replace some of these lost funds, including the New Markets Tax Credit program. Nonetheless, the net effect has been a loss of funding for CDFIs.

¹⁴ Kristen Moy and Alan Okagaki, “Changing Capital Markets and Their Implications for Community Development Finance,” *Capital Xchange Journal*, (July, 2001).

¹⁵ Mark Pinsky, “Taking Stock: CDFIs Look Ahead After 25 Years of Community Development Finance,” *Capital Xchange Journal*, (December, 2001).

communities left unaddressed by mainstream institutions, today's CDFIs are witnessing the evaporation of distinct gaps, to be replaced by smaller, more disparate pockets of need. This is not to say that low-income individuals are satisfactorily serviced by the commercial lenders, but rather to say that the introduction of competition means that CDFI customers now have choices. Of course, many of the non-CDFI institutions operating in distressed neighborhoods offer expensive, sub-prime services that leave the community as poor as it was prior to this access to capital. Nonetheless, the fact remains that the communities now have options, and that competition has required CDFIs to examine their models, long based on the notion of geographically specific services that assisted one specific community, and look instead to less localized services.

Clearly, the CDFI industry is experiencing growing pains. And while it is possible to say that some of those growing pains are the direct result of their own success – competition is entering these markets precisely because CDFIs have done such a good job of demonstrating the viability of servicing distressed communities – CDFIs are nonetheless in a somewhat precarious position in the capital markets. Given the obstacles created by decreased federal funds, increased competition and changing business models, it is no wonder CDFIs are beginning to turn to mainstream models to address their work. The next section examines the growing trend within the CDFI community towards more for-profit activities, and provides examples of how that trend translates into practice.

The Changing CDFI Landscape

As federal funds have evaporated and mainstream lenders have entered CDFI markets, today's CDFI industry has experienced a trend towards market-oriented strategies to preserve the organizations' positions in the capital markets. Before proceeding with a discussion of this trend, it is necessary to clarify what is meant by my phrase "market-oriented," as it is a term I use consistently throughout the paper and therefore requires an explanation. By definition, a market is a "public place where goods and services are traded, purchased and sold."¹⁶ When something is described as "market oriented," the implication is that the item is priced to be competitive in a world of buyers and sellers with a limited amount of demand and a limited amount of supply. If something is market-oriented, it is assumed that the good is priced to be able to compete with other sellers who offer the same good. Thus, when I describe CDFI strategies as becoming more market-oriented, I intend to convey that the strategy is either moving closer towards, and appears related to, an approach undertaken by traditional lenders. In other words, the CDFI is adopting a *mainstream* strategy to its own ends.

However, to say that a CDFI is becoming more market-oriented is contentious to the degree that it implies that perhaps CDFIs weren't market-oriented before. As Bob Schall, President of Self-Help Ventures Fund, explains,

"CDFIs have always had a market...[Before funding began to disappear] we had a market of foundations and of government subsidized funding. And it was a market. No more no less. It was regulated and open to new entrants, so it was very much a market, but just different than how mainstream lenders talk about markets. It wasn't mainstream or conventional, and it wasn't very large or efficient, but it was a market, just like the energy tax credit market we have now. It involved

¹⁶ AIG Valic. http://www.valic.com/valic2003/aigvalic.nsf/contents/edu_glossary-m. Consulted on March 28, 2007.

private money and public money that was channeled to different projects. That's a market."¹⁷

In other words, while it is fair to say that CDFIs are becoming more market-oriented in the sense that they are becoming more integrated into traditional financial markets and more adept at leveraging those markets to satisfy their mission, it is important to understand that CDFIs have always operated in a market. Of course, in previous decades the market for CDFIs was more inefficient and reliant on subsidized funds, as opposed to today's market which is considerably more efficient, competitive and, for some, expensive. It is this new market that is pushing CDFIs to recast the ways in which they engage with both their own funders and the low-income communities they serve.

Organizational Financing Mechanisms

As discussed earlier in this chapter, the financing landscape has changed dramatically since the inception of the CDFI industry. Early CDFIs relied primarily on grant funding, either from foundations or the government. However, this is no longer the case today. According to the 2004 CDFI Data Project, the 260 CDFIs surveyed received a total of 6% of their debt capital from foundations, with an additional 4% from the Federal government and a meager 2% from state governments.¹⁸ In other words, only 12% of all debt capital issued in 2004 came from foundations and governments, the two financing bodies initially responsible for the vast majority of funding to CDFIs. As a result, today's CDFIs are experiencing rising costs of capital as they increasingly transition away from grant funding towards financing that must be repaid, often times with interest.

¹⁷ Interview with Bob Schall, April 4, 2007.

¹⁸ Coalition of Community Development Financial Institutions.
<http://www.cdfi.org/cdfiproj.asp#fy>. Consulted on March 5, 2007.

To simply say that CDFIs can no longer rely on grants is to only tell one half of the story. Yes, it is true that CDFIs are now facing the realities of purchasing the funds they lend. However, it is equally true that in the midst of these increased costs CDFIs continue to cling to their mission of providing affordable financing to underserved communities. Thus, CDFIs find themselves in a bind. They are experiencing rising costs of capital, but hoping not to pass on those increased costs to their low-income borrowers who are unable to afford expensive, or in many cases simply market-rate, capital. At a minimum the CDFIs need to be financially sound to continue their work, and yet this diminishing spread between the cost of debt and the price of their loans is squeezing CDFIs, as it is this margin that CDFIs rely on to earn income and fund operations.

CDFIs are utilizing numerous tools to address this conundrum, including developing new, alternative financial instruments that consider not only the financing needs of the CDFI but also the mission component. One of the best examples of these creative, market-based financing instruments designed specifically for non-profit community development groups is the Equity Equivalent Investment, or the EQ2. Created in 1996 by the National Community Capital Association (now Opportunity Finance Network) in conjunction with the Ford Foundation and Citibank in an attempt to offer additional financing options to non-profit community development groups, the EQ2 functions like equity but is actually deeply subordinated debt. Here is how it works.

To keep things simple, think of the EQ2 is a loan with quirks. Like a loan, an EQ2 requires interest payments. Usually the interest rate is low – typically 2 to 4 percent, which is below market – and the terms are rolling, meaning that instead of a standard loan, which has a date of maturity, the EQ2 can be constantly renewed so that the

principal never comes due (though, technically, the lender has the right to call back the capital at some determined date). Usually, only interest payments are charged for the first ten years of the note so that the CDFI has smaller payments than it would if it were to make payments on both the principal and the interest. Usually, banks issue the EQ2, though a corporation, or another major institution like a foundation, occasionally issues them.

Traditionally, loans require that the funds be secured with the borrower's assets. However, CDFIs and other nonprofits only have limited collateral, meaning they have limited access to debt funding. Thus, the EQ2 allows CDFIs to access additional financing, funding without collateral, providing non-profits money they otherwise couldn't access if their assets were tied up in other loans. Similarly, because lenders want guarantees that they will be paid back, banks often times charge higher interest rates in order to accept a position as subordinated debt. However, with the EQ2, the lender takes the risk of providing subordinated debt, but doesn't get to charge the CDFI more money for holding that position. As a result, the usually costly subordinated debt that borrowers often can't afford is now reasonably priced. Suddenly this new tier of financing – subordinated debt – is not only affordable to CDFIs, but the coveted position of first lender is still available, enabling CDFIs to approach other financiers for affordable capital from first lenders. The fact that the EQ2 is not collateralized, and that it acts as subordinated debt, has the combined effect of providing CDFIs capital that is not only extremely affordable but also was previously unavailable.

The benefits to the CDFI of the EQ2 do not stop there. Because the lender cannot accelerate the repayment schedule, the CDFI has security in its ability to relend those

same dollars into distressed communities without fear that the issuer of the EQ2 will recall its investment. This sense of security is further enhanced by the fixed interest rate of the EQ2. Unlike most equity investments, whose rate of return increases as the borrower earns more income, the EQ2 interest rate remains fixed, meaning that CDFIs can keep a greater portion of the margin generated from relending the capital than they otherwise could with a traditional loan. Additionally, there is the rolling maturity date, which, in practice, results in a loan whose principal is never due. Instead, at the date of maturity the EQ2 simply rolls over into a new EQ2, and the CDFI continues making interest payments without repaying the principal. The result is an even heightened sense of security experienced by the CDFI who can now invest the EQ2 funds into low-income communities without concern for paying back the principal.

Clearly the EQ2 is not only an exciting innovation but also one that is producing results. As of 2001, Opportunity Finance Network estimated that roughly \$70 million in EQ2 investments had been placed by more than twenty commercial banks. According to their research,

“EQ2 capital has made it easier for CDFIs to offer more responsive financing products... the Chicago Community Loan Fund, one of the first CDFIs to utilize the EQ2, once had difficulty making the ten-year mini-permanent loans its borrowers needed. Instead, Chicago had to finance these borrowers with seven-year loans. With over 15% of its capital in the form of EQ2, Chicago can now routinely make ten-year loans and has even started to offer ten-year financing with automatic rollover clauses that effectively provide for a twenty-year term. Cascadia Revolving Loan Fund, a CDFI based in Seattle, finds EQ2 a good source of financing for its quasi-equity and long-term, real estate-based lending, and Boston Community Capital has used the EQ2 to help capitalize its venture fund.”¹⁹

¹⁹ Federal Reserve Bank of San Francisco.
<http://www.frbsf.org/publications/community/investments/cra02-2/equity.pdf>. Consulted March 25, 2007.

In other words, with the EQ2, CDFIs can engage in riskier and long-term lending.

The EQ2 is very much a market-based tool that not only brings CDFIs one step closer to the mainstream capital markets but also mimics the capital structure of many private businesses. As Lipson explains in her analysis of the need for the EQ2,

“unlike for-profit corporations, which can raise equity by issuing stock, nonprofits must generally rely on grants to build this base. Traditionally, nonprofit CDFIs have raised the equity capital they need to support their lending and investing activities through capital grants from philanthropic sources, or in some instances, through retained earnings. However, building a permanent capital base through grants is a time-consuming process, and one that often generates relatively little yield. It is also a strategy that is constrained by the limited availability of grant dollars.”²⁰

The EQ2 gets around this by essentially creating the nonprofit version of stocks, or equity. According to the CDFI data project, in 2004 roughly 3% of the capital structure of community development loan funds was from EQ2s, while 5% of community development venture fund dollars were invested into CDFIs via EQ2s. Banks remain the primary investors of EQ2s because banks can receive CRA credit for them.

A second major financial innovation was introduced to the CDFI community when Congress passed the Community Renewal Tax Relief Act of 2000, legislation that provided almost \$26 billion in targeted tax incentives and regulatory relief for community development. A pivotal piece of the legislation created a unique financing instrument called the New Markets Tax Credit (NMTC). Considered one of the most promising federal community revitalization efforts in decades, the NMTC program was established such that in its first year \$1 billion of investments would be eligible for NMTC, with annual increases every year thereafter.

²⁰ Ibid.

Under the new program, tax credits are allocated to federally certified “Community Development Entities” (CDEs) on a competitive basis. CDEs are broadly defined as a domestic organization both with a primary mission of serving low-income communities and explicit representation of low-income community residents on the organization’s governing or advisory boards. Though they run the gamut from mainstream commercial banks to small business investment companies to community development corporations, many CDEs are CDFIs.

CDEs that receive the tax credits issue equity interests to investors. Those investors then claim the tax credits, which are worth 39% of the cost of the equity investment, over a seven-year period. The investor receives a credit worth 5% of the value of the investment every year for the first three years, and then six percent annually for the next four years. For its part, the CDE is required to invest essentially all of the equity in “active low-income community businesses” in “low-income communities.” Generally speaking, the NMTC program does not fund housing – other tax credit programs exist to address this need – and focuses instead on non-profit and for-profit businesses including childcare and health care facilities, charter schools, office space and neighborhood retail establishments. Considered a major success among community development practitioners, the NMTC program has granted 223 awards valued at roughly \$12 billion to date.²¹

²¹ Community development Financial Institutions Fund.
http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5. Consulted on April 1, 2007.

Like the EQ2, the New Markets Tax Credit program is very much a market-driven response to community development needs. As Stockton Williams explains, when discussing the motivation for the program:

“despite extraordinary, largely untapped market opportunity, inadequate information and higher risks – both real and imagined – have made many financial institutions, investors and businesses reluctant to commit capital in distressed communities. Those that do invest demand higher rates of return than most investments yield. The New Markets Tax Credit is designed to bridge that gap. By increasing the after-tax return to investors that provide equity capital, the NMTC will lower risk for investors and businesses, while cutting the cost of capital for community development groups trying to bring business investment to their neighborhoods.”²²

In other words, the NMTC program is using the traditional risk-reward paradigm of the capital markets to create new financing structures for community development practitioners, leveraging market fundamentals to increase capital flow to distressed communities.

Other financing innovations continue to evolve within the CDFI community. For example, some CDFIs are exploring flexible loan products. Specifically, organizations may offer debt that can be converted into grants or equity depending on the ultimate outcome of the project. Examples of convertible debt instruments will be discussed in more detail in chapter two.

CDFIs and Market Analysis

First generation CDFIs did not need to give much thought to how best to segment customers or identify new markets, as their customers were handed to them via redlining

²² Federal Reserve Bank of San Francisco.
<http://www.frbsf.org/publications/community/investments/cra01-1/newmarket.pdf>.
Consulted on March 28, 2007.

and other discriminatory practices that left low-income neighborhoods starved for access to capital. In contrast, today's CDFIs are responding to the competition from mainstream lenders by carefully and conscientiously identifying niche markets that both satisfy the mission component of CDFI work while also offering viable investment opportunities. In order to identify such markets, the CDFI industry has created computerized market analysis tools that critique potential markets via relevant income and demographic statistics.

A good illustration of the CDFI industry's burgeoning market analysis methodologies can be found at The Reinvestment Fund (TRF), a large, Philadelphia-based CDFI that has invested over \$520 million since its inception in 1985. Though TRF began as a small community development organization focused on Greater Philadelphia, it has evolved into an investment fund serving the Mid-Atlantic Region whose good work has been written about in multiple newspapers, including the New York Times, the Washington Post and USA Today. Recently, in a step to better understand how to identify new investment opportunities, TRF introduced its data analysis tool called "Market Value Analysis (MVA)." As TRF explains, "the MVA creates a data driven framework for restoring market viability and wealth in distressed urban real estate markets."

Specifically, MVA uses the famous strategy of cluster analysis to "identify transitional areas that readily lend themselves to redevelopment and appropriate sites for affordable housing investment." MVA analysis is based on variables that include existing home value, occupancy rates, ratio of owner to renter, public assets and liabilities, private assets

and liabilities, transportation linkages and median income levels of immediate and surrounding communities.²³

MVA is not the only market analysis tool employed by today's CDFIs. In January 2006 Local Initiative Support Corporation (LISC) acquired MetroEdge, a research group that analyzes demographic and income data in low-wealth neighborhoods with an eye towards identifying untapped market potential in distressed communities.²⁴ Similarly, Social Compact now offers its Neighborhood Market DrillDown research that analyzes unmet needs, market risk, and patterns of aggregate wealth in poor communities as a means towards identifying viable, profitable markets.

That the CDFI industry not only recognizes the need for new markets but is also able to construct sophisticated data analysis instruments to identify such markets is a sign of the changing industry. No longer is it enough for CDFIs to operate solely on instinct or values, as they could in the 1960s. Rather, today's organizations are aggressively assessing market potential in much the same way as a mainstream institution, via data collection and analysis that will enable them to make targeted investments to achieve the greatest possible degree of success.

Technological Innovations in the Field

In an April 20, 2006 address by the Federal Reserve Board Chairman Ben Bernanke to the Greenlining Institute's thirteenth annual economic development seminar in Los Angeles, California, Bernanke opened by stating, "I have been particularly

²³ All TRF data from The Reinvestment Fund.

<http://www.trfund.com/planning/marketvalue.html>. Consulted February 20, 2007.

²⁴ LISC Metroedge. <http://www.metro-edge.com>. Consulted on February 20, 2007.

impressed, and heartened, by the increasingly high degree of professionalism in the [CDFI] field.”²⁵ In a speech bursting with examples of the industry’s heightened “professionalism,” Bernanke provides numerous illustrations of the ways in which technological innovations are creating opportunities for market-based initiatives for CDFIs, including the ability to leverage data to attract new investors.

Bernanke explains the situation well when he asserts that today’s CDFI

“managers and others with an interest in the CDFI industry have invested substantial effort in designing tools for data collection and analysis that focus on measuring the financial performance – the risk and returns – of CDFI portfolios. An important motivation for these efforts is the need to diversify funding sources for community development, which has relied heretofore largely on grants from government and foundations. To attract more return-oriented investors, including both conventional investors and those with social as well as financial goals, CDFIs must demonstrate financial viability as well as the ability to fulfill the broader development mission.”²⁶

Bernanke’s assessment of the technological transformations occurring within the CDFI industry is spot on. It is true that CDFIs are now considering their work not only through the lens of social impact, but also from the perspective of financial health. Whereas first generation CDFIs proudly embraced their status as non-profits working outside mainstream markets, today there is a more institutional recognition of the importance of measuring financial performance, as evidenced by the introduction of systems designed specifically to quantify CDFI financial performance, including Opportunity Finance Network’s “CDFI Assessment and Rating System,” which rates individual CDFIs’ credit worthiness.

²⁵ The Federal Reserve Board.

<http://www.federalreserve.gov/boarddocs/Speeches/2006/20060420/default.htm>.

Consulted on February 20, 2007.

²⁶ Ibid.

A second example of technological innovation within CDFIs is streamlined underwriting strategies that reduce the CDFI's operating costs and expedite business transactions more quickly. Borrowing a page from traditional lenders, some of America's most forward-looking CDFIs are experimenting with "technology-based credit scoring systems"²⁷ that generate a high number of transactions at a lower cost per transaction. While automated credit scoring is controversial within the CDFI community, and rare to date, virtually all CDFIs recognize the need to reduce transaction costs, via more efficient operations, to remain competitive. Hence, many CDFIs, like ACCION Texas, have reorganized their institutions around centralized underwriting departments with cutting edge software to assist in swift evaluations. Other CDFIs have granted lenders greater authority to approve loans up to a certain size without a formal underwriting process in order to further reduce transaction costs. That CDFIs are innovating via data collection and analysis is important, as it illustrates an understanding that the industry cannot remain competitive without targeted services and efficient delivery systems.

²⁷ Jeremy Nowak, "Civic Lessons: How CDFIs Can Apply Market Realities to Poverty Alleviation," *Capital Xchange Journal*, (March, 2001).

CHAPTER 2: INITIATIVE CAPITAL CASE STUDY

As discussed in the previous chapter, the CDFI industry is becoming more market oriented. For an illustration of the ways in which a small North Carolina-based, non-profit CDFI is responding to the changing trends in the CDFI industry, consider the story of Initiative Capital.

History of Initiative Capital

The North Carolina Community Development Initiative (The Initiative) was founded in 1994. According to their website, The Initiative is “a statewide public-private partnership that provides leadership and capital investment to high-performing community development corporations (CDCs) as well as other community based economic development endeavors (i.e. social enterprises) to improve the well being and quality of life for people in low resource communities.”²⁸ To satisfy its mission of revitalizing low-income communities, The Initiative offers grants, loans and technical assistance via two separate organizations, The Initiative, which is the parent nonprofit, and Initiative Capital, a federally certified, nonprofit CDFI incorporated in 1999 with the express purpose of providing below market financing to nonprofit developers.

In its first ten years (1994 – 2004), The Initiative (including Initiative Capital) injected more than \$25 million in high-performing CDCs that:

- Facilitated the construction of more than 2,100 single-family homes across North Carolina

²⁸ The North Carolina Community Development Initiative.
<http://www.ncinitiative.org/mission.cfm>. Consulted on February 20, 2007.

- Facilitated the construction of more than 2,100 units of multi-family housing throughout the state
- Invested in the development of more than 1.1 million square feet of commercial space.

It is estimated that these projects have resulted in an overall impact on the state of North Carolina that includes the creation of 9,350 new jobs, more than \$22 million in local government revenues, and over \$274 million injected into local economies via the multiplier effect.

With a relatively short but substantial track record, and a staff of roughly thirteen full-time employees, The Initiative has established itself as a significant player in the community development field in North Carolina. However, its model is unique. Where many CDFIs fund primarily businesses and real estate developers, The Initiative has targeted CDCs, many of whom have struggled to secure adequate funding to serve North Carolina's distressed communities. Because of its unique business model, The Initiative is an interesting case study for examining the ways in which the changing CDFI industry affects nonprofit CDFIs. For the purposes of this case study, I focus on the work of Initiative Capital and its specific approach to the changing CDFI industry, as opposed to the work of the larger entity, The Initiative.

Initiative Capital Business Model

Initiative Capital, as a nonprofit CDFI, has long placed mission over profitability, which is not to say that the organization is unconcerned with the financial performance of its investments. Rather, in quite the opposite fashion, Initiative Capital diligently

monitors its investments, and finances CDFIs with the expectation that loans will be repaid in full. However, the distinction is that Initiative Capital has always offered below-market interest rates on its loans, and herein exists an important variation among CDFIs. Some CDFIs, especially those with targeted rates of return similar to conventional market rates, lend their capital at interest rates similar to those found at traditional banks. Others, like Initiative Capital, offer lower rates in an attempt to provide affordable financing to projects that deliver increased social benefit to a distressed community, often in exchange for lower financial returns. Initiative Capital has always, and willingly, accepted this trade off between mission and profitability, believing that its job is to revitalize low-income communities by financing work that delivers needed services like affordable housing, locally-owned businesses and community facilities.

To that end, Initiative Capital conducts a rigorous screening process to identify qualified CDCs that have a demonstrated capability to put their financing to good use. To those that qualify, Initiative Capital offers a variety of loan products, each designed to serve a specific need within the state's nonprofit economic development community. In addition to offering grants to a select handful of CDCs, Initiative Capital offers flexible lines of credit, funds to acquire land for redevelopment purposes, and permanent financing for commercial or multi-family development projects.

Initiative Capital and the Changing CDFI Landscape

Clearly Initiative Capital has a strong business model that has produced measurable benefit. However, it is also a business model that is currently transforming to keep pace with the evolving CDFI industry. For starters, their lending terms are changing.

As mentioned earlier, Initiative Capital has traditionally offered its loan products at below market rates in order to make the capital affordable to CDCs. The reason that Initiative Capital has been able to offer cheaper financing is because it has always received that money at below market rates itself. As C. Everett Wallace, Initiative Capital president explains, for many years the commercial banks offered very cheap financing to Initiative Capital in order to meet CRA requirements. But this is no longer the case.

“In the past, lenders [from commercial banks] would lend to us at below market rates to get their CRA credit. But now they understand CRA better, and they know that they don’t have to lend the money at a below-market rate to a CDFI to get the credit. They understand that they can lend the money at market rate for a specific project, which is what Bank of America did in Charlotte. In downtown Charlotte, the entire First Ward was redeveloped by Bank of America, and they got CRA credit for those deals [because they invested the money in low-income areas of Charlotte] but they also got market rate return [because the loans were to for-profit developers]. So, while banks are still willing to lend us the same amount of money as before, it is now at market rate, which means our cost of funds is now higher. And if our costs are higher, that means our interest rates on our loans have to go up, so now we have to offer market rates to our borrowers, and they have to adjust their plans to account for the fact that they have to deal with those higher rates.”²⁹

Another reason Initiative Capital’s cost of funds has increased is because they now have to price the risk of their loans, a common practice among commercial lenders, but something they had previously avoided. Traditionally, lenders engage in risk-based pricing, which means that the lender adjusts the interest rate offered on the loan to account for the degree of risk associated with the loan. For example, if a lender is financing a new venture, or a project that has a higher probability of failing, the lender will charge the borrower a higher interest rate on the loan to account for that risk. Conversely, if the deal is less risky, the interest rate will be lower. Unlike its commercial

²⁹ Interview with C. Everett Wallace, February 6, 2007.

counterparts, Initiative Capital has traditionally avoided risk-based pricing models. Aware that virtually all of its loans would be considered high risk with such models and therefore be offered to borrowers at a higher cost, Initiative Capital instead approached its lending more concerned with offering terms that are affordable to borrowers. However, as its own cost of capital has increased, Initiative Capital has had to adopt a more market-oriented risk-based pricing model.

Again, Mr. Wallace:

“In the past, we could offer our CDCs a loan that was interest only for a few years with an eventual balloon payment down the road. Of course, this was really risky for us because there was always the chance that the borrower wouldn’t be able to make that balloon payment, but we didn’t price that risk. But now we have to consider that risk, and price our loan accordingly, which makes the money more expensive for our borrowers.”³⁰

The changing interest rate environment is not the only obstacle to Initiative Capital’s traditional business model. Rather, competition has also become an issue. According to Mr. Wallace, Initiative Capital’s market has not changed. Throughout North Carolina there are plenty of CDCs still in need of financing. However, the landscape of lenders willing to address that need has changed dramatically as traditional, commercial lenders have entered the field. To illustrate his point regarding increased competition, Mr. Wallace uses the example of affordable housing.

“Over the last ten years, the banks have realized that they can do an affordable housing deal profitably. So now, the CDCs that we lend to can go directly to a bank to get financing. And now the bank has not only the ability to do that deal, but also the willingness. Take the Wilson Community Improvement Association, for example. They have done enough deals that the local branch of Bank of America or BBT wants to be their lender. Initiative Capital started their work – we funded them first – and now they are bankable.”

³⁰ Ibid.

The question becomes, then, whether or not the Wilson group will chose to continue banking with Initiative Capital. Given that Initiative Capital's terms are no longer below market, it is harder for the CDFI to make an argument in favor of their loan over one from a commercial lender.

When asked if the increased competition and changing interest rate environment has impacted not only Initiative Capital's approach to doing business, but also that of the entire CDFI industry, Mr. Wallace vehemently answers yes.

“There is no question the industry has become more and more sophisticated. I mean, look at our office. Right here we have lawyers, MBAs, people with significant banking experience. It's exciting, and the industry as a whole is better off because we're getting talented people devoted to getting deals done. We have more sophisticated, younger folks entering the industry.”³¹

But not all the news surrounding the evolving CDFI industry is so positive. According to Wallace, Initiative Capital's business model has shifted in two subtle but profound ways. First there is the subject of who the organization funds. As mentioned earlier, despite the increased competition there is no shortage of CDCs in need of the types of financing offered by Initiative Capital. However, the more market rate terms that Initiative Capital has been forced to adopt does mean there are fewer CDCs who can afford Initiative Capital's terms, meaning the CDFI has had to expand its client base to consider financing deals it previously did not consider. Whereas in the past Initiative Capital's below market terms were offered exclusively to nonprofit organizations, usually CDCs, and almost always involved in either affordable housing or the development of community facilities, the CDFI is now considering deals from for-profit real estate developers and nonprofit social enterprises that include a revenue generating component.

³¹ Ibid.

While there is certainly nothing wrong with expanding its market to include these new deals, Initiative Capital's mission has always been to serve communities that are low resource and unable to access affordable financing, a description not often used in reference to for-profit real estate developers.

In addition to expanding its targeted market, Initiative Capital has had to revisit the ways in which it defines success with regards to satisfying its mission of revitalizing distressed communities. Because Initiative Capital now offers market rate terms, its borrowers have to design deals that can absorb the increased cost of funds. As a result, the borrower's project may change. Consider, for example, the ways in which the increased interest rate may affect an affordable housing project undertaken by a CDC. Assume that an affordable house is defined as a single family home that costs between \$65,000 and \$85,000. With below market financing, the CDC could build a certain number of homes and sell each of them at \$72,000, pricing them such that they are affordable to individuals at the lower end of the income bracket. With market rate financing, the CDC now needs to earn a better return on each house in order to afford the increased cost of the loan. So now, that same house sells for \$82,000, a \$10,000 increase in price. While the house remains affordable by the definition outlined above, it may be that the person who could afford the \$72,000 is priced out of the house at this new, higher price. The result is a house that is still affordable, and is still addressing someone's need, but, as Mr. Wallace says, in such a scenario, Initiative Capital "can't reach down as deep in the community."

Aware of the ways in which the changing interest rate environment, increased competition and general trend towards market-oriented approaches has impacted its

ability to satisfy its mission, Initiative Capital has turned to creative financing instruments in the hopes that alternative financing tools will offer them the flexibility to continue financing CDCs on more generous terms. For example, the organization just recently secured \$150,000 from a corporate donor to fund predevelopment activities for qualified CDCs embarking on real estate projects. Though Initiative Capital will disburse this money in the form of loans, the loans will be a flexible loan product unheard of in the commercial lending market. Specifically, if the CDC takes a loan from Initiative Capital, pursues the predevelopment activities, and concludes that the project cannot move forward, Initiative Capital can convert the loan into a grant.

The notion of a loan that can be converted into a grant in the instance where a project is no longer viable is tremendously beneficial to both the borrowing CDC and Initiative Capital. For the CDC, the fact that the loan can be forgiven if there is no project capable of producing revenues can be the difference between continuing to function and the accumulation of a paralyzing debt that can halt operations or, worse yet, lead to bankruptcy. At the same time, a loan that can convert to a grant helps Initiative Capital reach its mission of financing deals that should be done from a community needs perspective, but may not get done due to lack of profitability. Initiative Capital can lend the money for a deal with a high mission component and potentially low financial return, without worrying about the risk of financing such a project, secure in the knowledge that the loan can always be written off as a grant without hurting Initiative Capital's balance sheet.

In addition to this product, Initiative Capital will soon introduce another convertible loan product that they will offer to qualified businesses (as opposed to CDCs

or other nonprofits) wherein loan dollars can be converted into a percentage of ownership of the business. A third example of the organization's attempts at alternative financing is their entrance into syndication deals with traditional banks, teaming up with banks to jointly offer a loan that neither Initiative Capital or the bank would do on its own. Cognizant of the growing competition from commercial banks, and hoping to leverage that competition to better serve needy communities, late last year Initiative Capital raised a \$12 million fund from North Carolina banks to finance loans in partnership with traditional lenders.

Though \$2 - \$3 million of the fund's money will be used to provide grants to CDCs, the majority will be invested via syndication deals jointly with other banks. According to the Raleigh News and Observer, "the statewide program will also analyze lending opportunities on behalf of banks and assume some of the financial risk of the loans. Specifically, if a borrower gets turned down for a bank loan, the N.C. Community Development Initiative can step in with 10 to 15 percent of the amount requested and then the bank can agree to do the rest."³² The group-lending aspect of this fund is useful to Initiative Capital in two ways. First, it enables the organization access to deals it otherwise would not likely fund, perhaps because the loan amount requested is too large or because the borrower wants terms the organization can't offer. Additionally, by working together the lending institutions can offer a larger financing pool than any of them could offer on their own. Given that the entirety of the fund is designated exclusively for low-wealth communities, and that the majority of the monies serve to

³² Frank Norton, "Loan Syndicate Raises Funds," *Raleigh News and Observer*, (December 7, 2006).

subsidize larger deals, the fund has the capacity to invest many more than its own \$12 million into these underserved areas via these partnerships.

Initiative Capital has been able to offer financial products that remain useful to its borrowers despite the CDFI's own increased cost of funds. Nonetheless, the fact remains that the organization's lending model is changing. While Initiative Capital continues to fund much-needed community development projects in underserved communities, the reality is that not all of those funds can reach "as deep down in the community" as they may have in the past. Initiative Capital's business model is one that relies heavily on outside funding sources, meaning when the terms upon which the CDFI can secure operating funds become more costly, so too must the terms that it can offer its borrowers. In other words, there is a direct link between the CDFI's cost of funds and the income level of the population it is able to serve.

In this business model – a CDFI that does not collect deposits or engage in revenue-generating activities outside of lending - the more reliant a CDFI is on outside donors for operating funds, the less well able it is to target the lowest income communities. Conversely, the more financially self-sustaining the CDFI, the easier it is to offer lending products that are affordable to lower income families. The next chapter presents a contrasting case study in the story of Self-Help, a CDFI whose business model has better positioned the organization to maintain lower costs of funds despite the federal financing decreases currently plaguing the CDFI industry.

CHAPTER 3: SELF-HELP CASE STUDY

Initiative Capital is by no means the only North Carolina CDFI whose operations have evolved to keep pace with the changing CDFI landscape. Self-Help, a nonprofit credit union and CDFI based in Durham, North Carolina, has also revised some of its lending activities to respond to changing obstacles and opportunities in the CDFI community. However, unlike Initiative Capital, Self-Help maintains a business model that better positions the organization to reach North Carolina's most needy communities in the face of decreasing federal and private funds.

History of Self-Help

Founded in 1980, the Center for Community Self-Help and its financing affiliates – Self-Help Credit Union and the Self-Help Ventures Fund – collectively referred to in this paper simply as “Self-Help,” was launched under the belief that low-income individuals are not inherently riskier borrowers than those serviced by traditional lenders. Based in Durham, North Carolina, Self-Help is a CDFI with a mission to provide affordable financial services to people unable to access mainstream services. Specifically, Self-Help focuses on serving female, rural and minority borrowers throughout North Carolina, though the organization has recently expanded to provide financing to low-income residents in Washington, D.C. and a handful of other states.

Self-Help provides a wide array of financial products including loans to businesses and nonprofit organizations, financing for community facilities and charter schools, affordable mortgages for first-time homebuyers, commercial and residential real estate loans, and deposit accounts for individuals who want to conduct their banking at

the credit union. The CDFI also maintains an active secondary mortgage markets program that buys and sells mortgages issued to qualified low-income borrowers by mainstream lenders. Additionally, Self-Help has a research and advocacy affiliate – the Center for Responsible Lending - a "nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices,"³³ including predatory lending and subprime market activities. As of April 2006, Self-Help had invested a total of \$4.5 billion in 50,769 borrowers and had financed over 44,000 mortgages to low-wealth individuals through its secondary markets program.³⁴

The details of Self-Help's work are impressive. Since its inception the organization has:

- Issued 2,938 home loans valued at almost \$200 million. 77% of these loans were made to minority-headed households and 32% to female-headed households, while 36% of these borrowers were located in rural areas.
- Lent \$260 million in small business financing, through which the organization has almost 19,000 jobs. 47% of these borrowers are minority, 45% are located in rural areas, and 43% are female-owned businesses.
- Made 654 loans totaling \$111 million to support needed community facilities. Specifically, this financing has created 22,893 childcare spaces, 15,352 school spaces, 600 supportive housing spaces and established, or preserved, almost 7,000 jobs.

³³ Center for Responsible Lending. <http://www.responsiblelending.org>. Consulted on March 28, 2007.

³⁴ Self-Help Credit Union. <http://www.self-help.org/PDFs/SHImpact3-06-2.pdf>. Consulted on March 28, 2007.

- Financed the building/reconstruction of 72 houses, sold 65 houses, acquired 67 additional residential units for renovation, financed the construction of 15 commercial buildings totaling 583,000 square feet.³⁵

With a staff of roughly 250 people, and a degree of scale rarely achieved in the world of community development, today Self-Help is considered one of America's most successful, innovative CDFIs.

Self-Help Business Model

As mentioned previously, technically Self-Help is four separate organizations. There is the Center for Community Self-Help, the original nonprofit organization founded in 1980, responsible for “developing and coordinating Self-Help’s programs, raising resources, and advocating for economic opportunity.”³⁶ There is also the Self-Help Credit Union, a federally insured, state-chartered credit union founded in 1984 that collects market-rate deposits that it then uses to make both business and home loans. Additionally there is the Self-Help Ventures Fund, a second financing arm of Self-Help. The Ventures Fund, which was also founded in 1984, is a nonprofit organization funded by grants and donations and is responsible for the CDFI’s higher risk business loans, real estate developments and secondary market activities. Lastly, there is the Center for Responsible Lending, the advocacy group that was founded by Self-Help in 200, and maintains an affiliation with the organization, but is not directly involved in the CDFI’s lending activities. Though there are many varied activities that constitute Self-Help’s

³⁵ Ibid.

³⁶ Self-Help Credit Union. <http://www.self-help.org/aboutus/corporatestructure.asp>. Consulted on March 28, 2007.

community development work, this case study narrowly focuses on its commercial lending activities. Specifically, it considers how Self-Help's commercial lending activities have or have not changed since the CDFI received its first allocation of New Markets Tax Credits in 2003.

Self-Help began offering commercial loans in 1984. The commercial lending program grew steadily, such that in the year 2000 alone Self-Help made 184 loans totaling over \$18 million dollars.³⁷ Many of these loans were made through federal programs that already existed to support business lending, such as the Small Business Administration's 504-loan program. According to Bob Schall, President of the Self-Help Ventures Fund, at this time the majority of Self-Help's commercial loans were "generic, small business loans to one to twenty-person shops."³⁸ Self-Help's commercial loans were focused primarily on community facilities, including non-profit organizations and human services groups, with only one or two small -- meaning under \$1 million -- commercial real estate deals per year. Though they were already funding charter schools by now, those loans were restricted to North Carolina schools. Regarding product offerings, Self-Help's commercial products were generic. They offered loans for working capital, equipment and inventory with the standard one to seven-year amortization schedule while real estate-backed loans could sometimes qualify for a fifteen or twenty-year amortization schedule.

³⁷ Source: Self-Help, 2007.

³⁸ Interview with Bob Schall. April 4, 2007.

Self-Help and the Changing CDFI Landscape

In 2003, Self-Help received its first allocation of New Market Tax Credits. That year they were awarded \$75 million to invest in commercial deals in low-income communities. It was more money than they had ever received for commercial lending, as evidenced by the fact that they were averaging just under \$20 million in commercial lending activities per year prior to the introduction of the tax credits. Though excited by the opportunity to increase their impact, Self-Help also understood that they would have to significantly ramp up operations in order to keep their commitment to invest such a large sum of money. Again, Mr. Schall,

“we knew we couldn’t place all that money in North Carolina because there isn’t enough demand. We felt comfortable leaving North Carolina for charter school funding because we knew it was basically the same model, just different state rules. So we started doing a lot more charter school funding. But commercial real estate relies on local markets and you have to be a local player to sniff out those deals, so we haven’t done as much commercial real estate. We’ve done a few, like a deal we did for Habitat for Humanity in Charlotte, but we only do maybe four or five of those a year.”³⁹

In other words, the tax credit allocation enabled Self-Help to expand its geographic service area to finance charter schools in other states.

In addition to an increased geographic scope, Self-Help experienced an increased scale. According to Brian Schneiderman, Vice President of Real Estate and Facilities Lending, the tax credits significantly increased the scale of Self-Help’s work, both from the dollar perspective and with regards to the size of the project. Whereas the average commercial loan in 2000 was \$98,724, and the total commercial lending activity that year was roughly \$18 million, Self-Help made a single loan of \$40 million in 2004 to the American Tobacco Warehouse Campus through its NMTC program and lent almost \$50

³⁹ Interview with Bob Schall. April 4, 2007.

million in 2005, more than double its annual commercial lending activities since 2000..

As Mr. Schneiderman explains,

“sheer participation in the NMTC program encourages us to increase our lending, as measured by volume of dollars we lend. Currently we have \$170 million allocation in tax credits, and we have to get that money invested into good deals. To do that, we have to do larger loans, or, at least, the program certainly encourages larger loans, because it is easier to make a smaller number of bigger loans to hit that \$170 million than to try to make hundreds of small loans. And because we have been involved in the [NMTC] program for a few years, we have also become much more comfortable making those bigger loans because we have gotten more comfortable with risk. Now that we have done a \$40 million loan it is a lot easier for us to feel comfortable doing a \$3 million loan. So culturally we have experienced a shift in terms of our comfort with risk.”⁴⁰

While Self-Help is quick to credit the NMTC allocations with the expansion of its commercial lending activities, Mr. Schall is equally fast to make clear that the tax credits have not changed the fundamentals of Self-Help’s business model.

“[The NMTC program] hasn’t changed our bread and butter. Those pre-NMTC loans are still the majority of what we do. We still have the same branch system [we had prior to the tax credits], the same goals, the same mission, the same products. It’s just we’ve added on to all of that. With charter schools, for example. The tax credits allowed us to take an area where we had specialization, where we had capacity and people who understand the industry, and leverage that. So instead of limiting our use of our capacity to financing schools in North Carolina, the tax credits allowed us to expand outside the state. If we wanted to keep our capacity in charter schools, we would have had to do that anyway because there isn’t enough demand in North Carolina, and the tax credits allowed us to do that. So, they are an add-on, another tool. It’s allowed us to create different products with lower interest rates and longer amortization schedules, but that is in addition to what we already offer, not in place of our other products.”⁴¹

Mr. Schall’s assertion that the NMTC program has expanded, but not changed, Self-Help’s commercial lending activities is corroborated by an examination into data collected on the CDFI’s commercial lending history. The table below illustrates Self-Help’s commercial lending history in the three years prior to receiving the tax credits

⁴⁰ Interview with Brian Schneiderman, March 26, 2007.

⁴¹ Interview with Bob Schall, April 4, 2007.

(2000 – 2002) as compared to a randomly selected year – 2006 – during which the CDFI had tax credits. Before receiving the credits, Self-Help was consistently making about 185 – 200 loans per year, with a steadily increasing average loan size that indicated growth in their commercial lending activities. In 2006, though Self-Help lent more in NMTC loans than in non-NMTC loans (\$25,057,500 in NMTC loans as compared to \$21,245,925 in non-NMTC loans), the CDFI continued to invest a significant portion of its loans – 46% -- in the non-NMTC loans Mr. Schall calls Self-Help’s “bread and butter.”

Table 1: Self-Help Commercial Lending Activity

Year	Total Loans (\$)	# of Loans	Average Loan Size	NMTC Loans	# of NMTC Loans	Average NMTC Loan
2000	\$18,165,331	184	\$98,725	N/A	N/A	N/A
2001	\$30,301,179	199	\$152,267	N/A	N/A	N/A
2002	\$35,339,435	200	\$176,697	N/A	N/A	N/A
2006	\$46,303,425	214	\$216,371	\$25,057,500	9	\$2,784,167

According to Mr. Schall, Self-Help’s approach to commercial lending has not been affected by the introduction of the NMTC program because they haven’t allowed it to be. That is, Self-Help has made a conscious effort to maintain its commitment to its mission in the face of an increase in potential borrowers. “Developers know about the tax credit program, and they shop around between lenders trying to get the lowest price on a loan, so we get people who show up wanting a loan from us, not because they care about our mission but because they think they can get a good deal with the tax credits.” Those are the deals Self-Help tries to avoid financing, though Mr. Schall admits that some of those deals do “slip through.” In fact, he readily acknowledges that the demographics of the real estate deals financed through the tax credit program are different than those of

Self-Help's other borrowers. "If you look at the NMTC real estate deals apart from the rest of the commercial portfolio, my guess is that you probably won't find any minority or women-owned businesses or any activity in our rural markets. Some jobs have been created – the loans hit those targets – but these loans don't necessarily hit the other mission targets we set for Self-Help, to service women and minorities and rural areas."⁴²

Though Self-Help's lending activities may not be directly affected by the introduction of the NMTC program, the CDFI has felt the affects of a changing CDFI landscape in two other key arenas – competition and the financing its own operations. According to Laura Benedict, who directs the Commercial Lending group at Self-Help, the lending activities that Self-Help has undertaken via the NMTC program has pushed them into a more competitive market. Ms. Benedict explains, "As we go outside of North Carolina, and do bigger transactions, the environment is much more competitive. We end up competing [with banks] for business."⁴³ Mr. Schneiderman concurs.

"Through the NMTC program we have added a new sliver to our market that perhaps wasn't there before. For example, consider the \$40 million American Tobacco project. We couldn't get that deal now if we tried because the NMTC program is a proven entity, and traditional banks are comfortable with it, so they would be willing to do that deal. When we did it, the program was new, and banks were hesitant, but we knew the program and knew the Durham market, and felt comfortable we could take over that project if we needed to, so we did the deal. So, whereas that deal used to be exclusively in our market, banks are now willing to do it, and will compete with us to do it, so banks have entered that section of the market, a section they used to avoid. As a result, we have also started looking to deals that maybe we wouldn't have done in the past as we start to explore new markets that aren't being served by banks."⁴⁴

⁴² Ibid.

⁴³ Interview with Laura Benedict, February 13, 2007.

⁴⁴ Interview with Brian Schneiderman, March 26, 2007.

Another market change Self-Help has had to contend with is the decrease in traditional funding sources for CDFIs. As discussed in chapter one, federal funding for CDFIs have been cut significantly in the last six years, including budget cuts for the CDFI Fund, the Small Business Administration Microloan program, and other indirect federal funding sources that CDFIs have come to rely on, including HUD and USDA funding for community development initiatives.⁴⁵ At the same time that federal funds have evaporated, so too have funds provided by banks. The recent trend in bank mergers has resulted in fewer aggregate dollars available to CDFIs. Whereas Bank A and Bank B may have each invested \$50 million in low-income communities prior to a merger, they may chose to invest a total of \$50 million between the two of them once they merge, placing a capital strain on CDFIs that rely on banks for affordable financing. Add to this the fact that federal regulations surrounding the CRA requirements have been loosened under the Bush Administration and the result is even less money available to CDFIs from the banking community. Even the foundations have decreased funding for CDFIs, wanting instead to target other, newer development initiatives. Thus, while these subsidized sources of funding still exist, the amount of funding available is decreasing quickly. And yet, the CDFI industry continues to grow as more organizations spring up every year. The result is a dramatic market shift in financing sources for CDFIs.

⁴⁵To illustrate the ways in which decreases in federal funding for programs seemingly unrelated to CDFIs can affect CDFIs, consider the example of federal funding for childcare. The Bush Administration has cut childcare subsidies for low-income families, meaning that there is now less demand for childcare services because low-income families that could previously use federal monies to cover the cost can no longer afford the service. The decreased demand for services has resulted in a decrease in the number of loans Self-Help makes to child care facilities, resulting in a negative net growth in the number of affordable child care slots available in distressed communities.

Self-Help's ability to weather such tumultuous financing storms is stronger than many other CDFIs and has been bolstered in large part by the fact that it is a self-sustaining organization. Since 1988, Self-Help has been able to finance its operations internally, without relying on outside grant funding. As a result, Self-Help has maintained a protective buffer between itself and the whims of potential funders. Additionally, because Self-Help is a credit union that collects deposits from its customers, it can rely on those deposits to finance its lending activities. According to Mr. Schall, even when offering competitive rates to its customers, deposits are often a cheaper source of capital for Self-Help than bank loans.⁴⁶ Like its ability to be self-reliant, Self-Help's access to deposits is a relatively unique characteristic among CDFIs, as most are not depository institutions.

Despite these advantages, Self-Help has had to adjust its business model to remain strong in the face of the changing world of CDFI financing. Specifically, the organization has undertaken four strategies to strengthen its position in light of decreases in subsidized funding. First, Self-Help has streamlined its operations to increase efficiency. This has been accomplished both through the adoption of improved technologies and also through a concerted effort to concentrate on areas where Self-Help has a higher probability of completing deals. Second, Self-Help continues to improve its financial performance by accentuating its more profitable products. Though it offers a wide array of loans, the CDFI currently has a preference for those with the best financial return for the organization. Third, Self-Help has taken a firmer approach to pricing its loans. According to Mr. Schall, "in the early days we were more willing to compromise

⁴⁶ Interview with Bob Schall, April 4, 2007.

on interest rates in order to get a deal done but today we aren't as willing to do that.”⁴⁷

Lastly, Self-Help has learned how to use mortgages as collateral in the secondary market, a very market-oriented approach to improving financial performance.

Traditionally, secondary mortgage market transactions are brokered through banks that serve as an expensive middleman in the transaction. However, Self-Help has devised a method of buying and selling mortgages in the secondary market without using a bank. Instead, Self-Help goes directly to Wall Street, “to investment banking houses, to the same place the banks go to borrow money.”⁴⁸ In doing so, Self-Help can decrease the cost of the transaction, and generate a larger return. The result is a highly profitable, market-oriented method of financing its operations.

The result of such innovative strategies is a pricing model that remains relatively affordable to Self-Help's borrowers. Though Mr. Schall concedes that the organization has had to “revisit the pricing of some of its products,” in general the organization has been able to avoid an increase in what it charges its borrowers by aggressively attracting deposits, leveraging the secondary mortgage market to finance its operations and streamlining its processes to generate maximum efficiency.

⁴⁷ Ibid.

⁴⁸ Ibid.

CHAPTER 4: CONCLUSIONS AND POLICY RECOMMENDATIONS

The changing industry landscape affects CDFIs both with regards to the way they finance their own operations and the financial products they are able to offer their borrowers. A financially self-sustaining CDFI, like Self-Help, is much better positioned to weather the current decline in federal funding for CDFIs than a smaller organization like Initiative Capital, who has had to turn to the traditional capital markets for more expensive funding. In addition to the greater availability of funds traditionally enjoyed by CDFIs whose business model incorporates revenue-generating activities, these sorts of organizations also benefit from a lower cost of funds. Because operations can be internally funded by a self-sustaining CDFI, the organization is usually under less pressure to achieve high rates of returns on its investment than those CDFIs who borrow from outside lenders. The result of this lower expected return on investment is an increased ability to assist individuals farther down the income scale.

The degree to which a CDFI does or does not rely on external funding to maintain its operations significantly impacts the services it can offer its borrowers. Initiative Capital, for example, who relies more on market-rate financing to maintain its operations, has to price its loan products such that they can repay their own loans. Conversely, Self-Help, whose funding is primarily either internally generated or pulled from its customers' deposits, can target a lower required rate of return of its products, in turn enabling them to offer more affordable services to their customers. In the same way that larger CDFIs appear to have more control over their financing sources, they also seem better able to control the way they price their products than smaller CDFIs, whose pricing strategies are more subject to whatever obligations they have to their lenders.

In other words, if a CDFI can access cheap capital to fund its operations, it can provide cheap loans to low-income communities. If the CDFI has to borrow more expensive capital to fund its operations, its loan products may not be affordable to such low-income communities and instead may target a more low-to-moderate-income community. Certainly, both low- and moderate-income neighborhoods are in need of, and benefit from, the financial services provided by CDFIs. Thus, the distinction between serving the very poor, poor, or moderate-income populations is not one of which type of CDFI is doing better work – it is all extremely valuable work. Rather, it is simply an observation about the relationship between a CDFI's cost of funds and the communities it is best able to assist. Ultimately, larger CDFIs that are financially self-sustaining appear better equipped to address the needs of low-income communities than smaller organizations that rely on outside loans, grants or other sources of subsidized funding.

Regardless of an organization's scale or its ability to generate its own funds, both small and large CDFIs are revisiting their business models to respond to the changing CDFI landscape. In some instances, CDFIs are adopting strategies more commonly used by traditional lenders to refine their models, including more technologically advanced data analysis tools that both increase efficiency of operations and identify new market niches. CDFIs are also exploring alternative financing instruments, including EQ2s, New Market Tax Credits, the mainstream secondary mortgage market and convertible debt products. Such innovations in the field indicate a greater trend towards more market-oriented operations and are a sign of the pressures felt by some CDFIs to increase the efficiency of their operations in order to reduce operating costs and pay back the loans they rely on to fund their work.

That CDFIs appear to becoming more innovative and business savvy is a good thing. Increased efficiencies should eventually lead to reduced operating costs that CDFIs can pass on to their borrowers in the form of more favorable lending terms (though this may take time, as CDFIs may need a few years to adjust to the new business models). Additionally, the more targeted approach to provision of services stemming from the introduction of market analysis techniques should result in a greater distribution of CDFI services to needy communities. As CDFIs become more skilled at identifying unmet demand, more communities will be granted access to affordable financial services, and in turn the current disparities that exist between those who can access affordable financing services and those who can't will lessen.

In some cases, the CDFIs themselves may even benefit from the pressure to streamline operations and improve financial performance. The need to adapt, to create alternatives, was one of the major catalysts for the creation of the CDFI industry initially, and it is that same knack for innovation that birthed the EQ2, the New Market Tax Credit program and many other key tools of the CDFI community. It is likely, then, that some CDFIs will respond to the increasingly market-driven expectations with new and equally exciting and important innovations that will continue to extend the capabilities of the CDFI industry and create new opportunities to alleviate poverty. Of course, some CDFIs will not be able to conform to the changing standards, and therefore may not exist in five or ten years. While the failure of a CDFI is unfortunate, there is something to be said for survival of the fittest. In a market that is growing increasingly competitive, it may be that only those CDFIs with the most talent, the greatest number of resources, and the best

business acumen will thrive. In other words, the CDFI industry may become as competitive and efficient as the mainstream capital markets.

Whatever the fate of any individual CDFI, it is obvious that each CDFI is somewhat unique and therefore faces its own advantages and obstacles. What may work well to strengthen one CDFI may be irrelevant to the operations of another organization. Nonetheless, there are certain initiatives that should be undertaken in North Carolina to support and bolster the state's CDFI industry. Specifically, I suggest the creation of a state CDFI fund as well as the development of a CDC partnership program, as outlined below.

Policy Recommendation #1: Establish a State CDFI Fund

Presently, North Carolina does not have a state CDFI fund. Instead, CDFIs hoping to receive state money must lobby the state legislature for direct appropriations. The fact that there is no systematic process or dedicated funding stream from the North Carolina General Assembly results in three negative consequences. First, there is the issue of CDFI's limited access to the legislature. Only the state's largest CDFIs have the staff and financial resources necessary to lobby for funds. Smaller CDFIs with more constrained operating budgets may be unable to participate in lobbying efforts, in turn excluded from the possibility of receiving state funding. In 2006, for example, only three of North Carolina's CDFIs received state appropriations – Self-Help, the Latino Community Credit Union and the Minority Support Center. Not surprisingly, these are three of the state's largest CDFIs.⁴⁹ An established state fund would rectify this unequal access to

⁴⁹ Interview with David Beck, February 22, 2007.

state funding by offering a standardized application process available to all interested CDFIs.

Second there is the problem of unpredictability of outcomes for those CDFIs who do engage with the state legislature. Organizations with the resources necessary to lobby suffer from the current arrangement, as lobbying is an expensive, timely, difficult undertaking that may or may not result in increased funding for the organization. Lobbying has the potential to be a tremendous waste of a CDFI's very limited resources, as there is always the possibility that the CDFI will simply be refused an appropriation, regardless of the strength of its lobbying efforts. In this regard, the act of lobbying is a gamble that an organization devoted to alleviating poverty should not have to take in order to achieve state support.

A further consequence of the current, haphazard funding process is that it is inconsistent. Because there is no dedicated funding source, CDFIs are left to cobble together state monies from a miscellaneous collection of whichever agencies are willing to provide funding. As a result, CDFIs can spend sizable resources trying to attract relatively small state funds from one agency, only to then have to repeat the process with a second, third, or sometimes fourth agency. Such an inefficient, unreliable approach could be swiftly erased with the introduction of a state CDFI fund.

In addition to creating a standardized process and providing equal access to government resources for all North Carolina CDFIs, a state fund would increase the volume of state dollars available to our CDFIs. In light of the decline in federal funding and foundation grants for CDFIs, the introduction of new state money would greatly bolster the state industry.

Though only a handful of states currently have CDFI funds, the bottom line is that they do exist, meaning there are models available to study and/or replicate. Specifically, Pennsylvania, Maryland, and New Jersey have active funds and North Carolina could establish a fund based on one of these funds.⁵⁰ If a state fund were not a viable option, an alternative would be for the General Assembly to provide dedicated funding for CDFIs in the state's recurring budget.

Potentially, a state fund could maintain funding priorities to support the work of smaller CDFIs operating in communities with a greater need of financial services. Specifically, smaller CDFIs that serve North Carolina's more rural areas are often the same organizations that struggle to secure funding. Thus, a state fund could prioritize supporting the work of these organizations, CDFIs that have not yet reached critical scale but have demonstrated potential via a 3-to-5 year history of successful work. Though all CDFIs could be eligible for funding from a state CDFI fund, rotating preference for smaller – but high functioning – organizations could help to compensate for the current unequal access to state funding and build the capacity of high potential organizations.

Alternatively, a state CDFI fund could maintain geographic funding priorities so that every few years a selected region of North Carolina receives a majority of available state CDFI dollars. Such a strategy would leverage the impact of CDFI dollars by injecting substantial, concentrated capital into a single region, bolstering the entire CDFI community in that section of the state and creating opportunities for regional collaborations.

⁵⁰ Ibid.

All North Carolina CDFIs, large and small, financially self-sustaining or reliant on outside funders, would benefit from a dedicated source of state funding. Such a fund would increase the availability of dollars to support the important and proven work of CDFIs. The result would be not only a strengthened CDFI industry in the state of North Carolina, but also an improvement in the lives of the state's underserved communities. With increased state support for CDFIs, North Carolina would experience an increase in the availability of affordable housing and quality childcare facilities, improved delivery of financial services to distressed communities, and the creation of new jobs, to name just a few benefits.

Policy Recommendation #2: Develop local development capacity

According to Bob Schall, one of the biggest obstacles preventing North Carolina CDFIs from better serving low-income communities is a lack of strong real estate developers active in community development projects. As he says, "on the development side, there isn't really anyone focused on community development needs. Sure we have strong developers but they are focused on the low-hanging fruit, on the easy projects. When we are trying to fix poor neighborhoods, there aren't many good developers out there that we can work with."⁵¹

To address the need for strong real estate developers committed to community development projects, North Carolina must bolster the capacity of existing real estate developers, namely Community Development Corporations (CDCs). CDCs are nonprofit organizations with a mission to serve the needs of local low-to-moderate income

⁵¹ Interview with Bob Schall, April 4, 2007.

communities. They are the obvious choice for community development projects because, by definition, they maintain a mission to engage in this sort of work. Thus, they share an alignment of vision with CDFIs, in addition to the fact that the majority are actively involved in real estate projects.

To strengthen North Carolina's CDC community, the North Carolina Association of Community Development Corporations (NCACDC), the trade association for North Carolina CDCs and CDFIs, should develop a partnership program between CDCs. With few exceptions, the vast majority of North Carolina's CDCs are small organizations that serve tiny, relatively rural communities. Because of their limited resources, combined with the fact that their service areas are geographically constrained and far apart from one another, most of these CDCs have limited capacity to do real estate deals. It may take them a few years to raise the funds necessary to build a project and then they may wait a few years before undertaking a second project, needing the time in between to identify new property and raise additional funds. During this couple year lag between projects, the organization may experience staff turnover, and with that, the loss of any institutionalized knowledge about how to do a real estate deal. The result of this on-again-off-again approach to development is that the CDC usually has to start every project over from scratch, at square one. Such a cycle is not only inefficient but also a barrier to developing organizational capacity.

The partnership program would facilitate partnerships between local CDCs working in different, local communities within the same 100-mile area. Those CDCs would then agree to work together to service the 100-mile area instead of focusing exclusively on their smaller community. Without necessarily merging organizations, the

partnering CDCs could leverage existing networks and local knowledge to jointly undertake annual real estate deals in the larger area. The combined increase in resources and organizational capacity would result both in an increase in the number of community development-oriented real estate projects completed in rural North Carolina and the simultaneous increase in institutionalized capacity to undertake such projects.

Potentially, high performing CDC partnerships could even become gatekeepers, of sorts, for community development projects in that region of the state. That is, if Self-Help wants to fund a project in southwest North Carolina, and needs a developer to do the deal, Self-Help would know to contact the CDC in charge of the CDC regional partnership for that part of the state. Together, Self-Help and the CDC could investigate potential developers and jointly determine how best to proceed with the project.

A partnership program should be a success if for no other reason than the strong mission alignment among CDCs and between CDCs and CDFIs. Both CDCs and CDFIs exist to improve distressed communities, and both sorts of organizations rely on mainstream financial activities, including real estate development projects and loan funds, to satisfy their missions. Thus, it is reasonable to forge partnerships among organizations in order to leverage existing resources and expand service areas.

A strong partnership program, coupled with a well-funded state CDFI fund, could substantially improve the performance of North Carolina's CDFIs and CDCs. Organizations would be better capitalized, better networked and able to reach more needy communities. The result would be an increase in the availability of needed services for our state's distressed communities, and with it the potential to decrease the state's poverty rates. Every North Carolinian would benefit from such an achievement.